Submission

By

Business NZ

To

Policy Advice Division,
Inland Revenue Department

On the

Officials' Report to the Government on the Taxation of Inbound Investment

30 November 2002

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OFFICIALS' REPORT TO THE GOVERNMENT ON THE TAXATION OF INBOUND INVESTMENT

SUBMISSION BY BUSINESS NEW ZEALAND

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1. Introduction

1.1 Encompassing five regional business organisations (Employers' & Manufacturers' Association (Northern), Employers' & Manufacturers' Association (Central), Canterbury Employers' Chamber of Commerce, Canterbury Manufacturers' Association, and the Otago-Southland Employers' Association), Business New Zealand is New Zealand's largest business advocacy body. Together with its 49-member Affiliated Industries Group (AIG), which comprises most of New Zealand's national industry associations, Business New Zealand is able to tap into the views of over 76,000 employers and businesses, ranging from the smallest to the largest and reflecting the make-up of the New Zealand economy.

1.2 In addition to advocacy on behalf of enterprise, Business New Zealand contributes to Governmental and tripartite working parties and international bodies including the ILO, the International Organisation of Employers and the Business and Industry Advisory Council to the OECD.

1.3 Business New Zealand's key goal is the implementation of policies that would see New Zealand retain a first world national income and regain a place in the top ten of the OECD (a high comparative OECD growth ranking is the most robust indicator of a country's ability to deliver quality health, education, superannuation and other social services).

1.4 It is widely acknowledged that consistent, sustainable growth well in excess of 4% per year would be required to achieve this goal in the medium term. Growth comes from increasing the inputs into the production process (e.g., employment and investment) and using these inputs more productively.

1.5 Investment and employment are critical inputs of production, but whereas employment growth has been very strong over the past few years, growth rates in business investment have been much less spectacular. As scope for further large increases in the number of people employed will likely become more limited as unemployment falls and skills shortages grow, the need for more and better investment will become increasingly urgent if New Zealand is to lift itself onto a higher path of sustained economic growth.

1.6 The tax system has a critical role to play in attracting investment and fostering a dynamic and innovative economy. Tax rates that are set at high levels, and compliance requirements that are complex and costly for businesses and individuals impose significant costs on the community. These costs include lower investment, output, incomes, and employment as well as distortions in behaviour.

1.7 When it was elected, the present Government undertook a number of policy actions to correct what it perceived to be 'failings' of the 1984-99 period's emphasis on market-driven economic reform. However, while Business New Zealand can understand the Government's wish to re-balance social and economic priorities, we submit that it is now time for the Government to concentrate on building the foundations for a strong and growing economy, without which desirable social and environmental outcomes are impossible.

1.7 Delivering such a strong and growing economy requires the adoption of a balanced, credible growth strategy. The Government's *Growth and Innovation Framework (GIF)* is a useful strategy statement in that it sets a goal of lifting New Zealand's OECD ranking and identifies the importance of innovation as a growth driver. However, we consider that its primary focus on encouraging innovation in three 'chosen' sectors[1] will not be sufficient on its own to lift New Zealand onto a higher path of sustainable economic growth.

1.8 Business New Zealand welcomed the statement in the Governor General's Speech from the Throne, on the opening of the 47th Parliament on 27 August 2002, which said:

"My Government sees its most important task as building the conditions for increasing New Zealand's long-term rate of economic growth."

1.9 While Business New Zealand is pleased that the Government is now talking about the need for higher economic growth, there has been little evidence to date that the Government is moving to implement or prioritise a credible growth strategy and policy direction that would spur the economy onto such a higher growth path. To date, a number of key policy decisions have at best merely confirmed the low-growth status quo or at worst have been in the wrong direction and damaged New Zealand's growth potential. Increased tax rates are a notable example of the latter type of decision.

1.10 The OECD in its recent review of New Zealand said that policies in all areas must have a growth promoting focus if we are to set the stage for higher living standards[2]. In practice though too many policies stifle growth and innovation, and too many spending initiatives divert scarce resources from more productive alternatives or are of dubious quality. In our view, there is often a conflict between growth promoting policies and initiatives and those that seek primarily to regulate activity and/or redistribute income. The OECD also commented on this.

1.11 We submit that a greater and more concerted focus on improving New Zealand's economic fundamentals is necessary – including efforts to improve the quality of government spending, reduce the burden of taxation, and more proactively address business compliance costs. More concerted effort in these areas will improve the New Zealand investment environment and make

[1] The three sectors identified in the GIF as being of high priority are biotechnology, creative industries, and information and communication technology.
[2] *OECD Economic Survey of New Zealand*, OECD May 2002.

this country a more attractive place for both foreigners and locals to invest in new and existing business ventures.

2. Summary of Recommendations

2.1 Business New Zealand is pleased to have the opportunity to comment on the officials' report to the Government on the Taxation of Inbound Investment in response to the 2001 Tax Review's recommendation for a lower rate of tax for new foreign direct investment (FDI).

2.2 Business New Zealand submits that the best way to attract much needed higher levels of business investment would be through a reduction in the overall tax burden, particularly the corporate tax rate, and a more concerted effort to improve the overall economic and regulatory environment. This would be fairer and more effective than applying a lower rate of tax just for new FDI, a proposal Business New Zealand does not favour.

2.3 Business New Zealand recommends that:

(a) The Government should recognise the importance of higher levels of business investment, from both foreign and domestic sources, for a higher rate of economic growth;

(b) The Government should recognise the importance of an internationally competitive tax system to attract and retain both foreign and domestic investment;

(c) The Government should work proactively with the Australian Government to make the resolution of triangular taxation a high priority;

(d) The Government should lower tax rates, with a priority on reducing the corporate tax rate for all businesses over time from 33% to 20%;

(e) Treasury and IRD should develop dynamic models to forecast the fiscal and economic impact of changes in tax rates; and

(f) The Government should do more to address the overall economic and regulatory environment to make it more conducive to both foreign and domestic investment and more competitive vis-à-vis other countries.

3. The Importance of Investment to Economic Growth

3.1 Putting it simply, economic growth comes from increasing the inputs into the production process (e.g., employment and investment) and using these inputs more productively. During the 1970s and 1980s New Zealand had a particularly poor record at both, with real per capita economic growth only averaging around 0.7% per annum. During the 1990s, New Zealand did rather better, averaging around 1.4% per annum, but this improved rate is still lower than New Zealand requires if it is to make up lost ground on the top half of the OECD.

3.2 Traditionally, there has been a positive relationship between employment and investment growth. During the 1990-92 recession, both experienced sharp declines, which was followed by a period of particularly strong growth in both employment and investment from 1994-96. Both then fell again during the 1997-98 recession, but from 1999 there has been something of a discontinuity in the link between the growth rates of employment and investment.

3.3 Employment growth has been strong since 1999, with employment increasing by 128,000 during the three years to September 2002, and the unemployment rate falling from 6.8% to 5.4%[3]. However, investment growth has been much less spectacular over the past few years. Although it recovered from its decline during the 1997-98 recession, investment has grown much more modestly (currently around 6% per annum) compared to the mid-1990s expansion (when it peaked at 20% per annum)[4].

3.4 The situation for FDI has been similar. The total stock of FDI rose rapidly from 13.7 billion in 1990 to $63.0 billion in 1998, but since 1998 FDI inflows have been almost static, with the stock of FDI rising only slightly to $63.8 billion in 2000[5]. From 2001, Statistics New Zealand changed the way it measures international investment without publishing any revised back-data, which has unfortunately made comparisons with previous years impossible. Under this new measurement, FDI in New Zealand was estimated to be $49.7 billion as at 31 March 2001, an amount that fell by 2.8% to $48.3 billion as at 31 March 2002[6]. New Zealand's poor performance in attracting and now even retaining FDI is probably a significant factor behind New Zealand's slow overall growth in business investment since the late 1990s.

3.5 So, why has New Zealand done so poorly over recent years in growing business investment and attracting and retaining FDI? There are a number of possible answers to this question, some of which are listed below:

- There has been a reduction in privatisation and merger and acquisition activity in New Zealand over recent years.
- After enjoying almost exponential growth in the late 1990s, global FDI flows have slowed significantly since 2000, reflecting international economic weakness, particularly in the US, Japan, and Europe.
- More countries (particularly in Asia) have 'opened for business' since the mid-1990s, so dramatically increasing competition for FDI.
- New Zealand has a very small economy (only around 0.2% of world GDP) and, as a result, in a very competitive market for FDI we barely register with world investors.
- New Zealand's economic and regulatory environment has over time become less competitive relative to the competition, with policy signals at best mixed and at worst off-putting to investors, both foreign and domestic.

[3] *Household Labour Force Survey – September Quarter*, Statistics New Zealand, November 2002.
[4] *Economic Overview*, Westpac Trust, September Quarter 2002.
[5] *Building the Future – Using Foreign Direct Investment to Help Fuel New Zealand's Economic Prosperity*, Boston Consulting Group, 2001.
[6] *Balance of Payments and International Investment Position – Year Ended 31 March 2002*, Statistics NZ, August 2002.

- A significantly lower value of the New Zealand dollar since 1998 has made it more expensive for businesses to import capital (although it should be noted that the dollar has appreciated throughout 2002 and exchange rate fluctuations are inevitable).

3.6 Business New Zealand acknowledges that some of the issues listed above are totally beyond the Government's control, but in our view they make it even more important that New Zealand has an economic and regulatory environment that is conducive to both foreign and domestic investment and more competitive vis-à-vis other countries.

3.7 In a speech to the New Zealand Association of Economists in June 2002, the Minister of Finance recognised that 4% GDP growth could be achieved via a combination of a modest increase in total factor productivity, a higher rate of labour force growth, and an increase in capital investment growth from its historic rate of 2.7% per annum to 4.5% per annum[7]. Despite this acknowledgement, there seems to have been little recognition to date that appropriate policies are needed to facilitate such an increase.

3.8 Although the 2001 Tax Review regarded 'increased levels of FDI as essential if a real attempt is to be made to significantly increase GDP per capita'[8], the officials report was rather more cautious about the benefits and costs of FDI and made no mention of the fall-off in FDI over recent years and the possible reasons why. It is unfortunate that the officials' paper did not discuss these issues and that it was so blasé about New Zealand's poor investment performance. Until progress is made in this area, New Zealand will struggle to lift its long-term rate of economic growth in a sustained manner.

3.9 *Business New Zealand recommends that the Government recognise the importance of higher levels of business investment, from both foreign and domestic sources, for a higher rate of economic growth.*

4. International Competition for Investment

4.1 Globalisation has not only increased international capital flows, but it has also exposed countries to greater competition for these flows. Much has been written about the risks and opportunities globalisation carries, particularly for small, open economies such as New Zealand. For New Zealand, the principle risks must surely come from failing to react positively to the inevitability of globalisation and failing to make the best of those risks and opportunities it brings.

4.2 In responding to globalisation New Zealand must do that much better than its larger and better-known competitors for international capital flows. This not only has implications for attracting new FDI, but retaining existing FDI and even the capital of domestic investors – in this context it is important to note that New Zealand direct investment abroad rose from $10.4 billion in 1998 to

[7] Opening Address at the New Zealand Association of Economists Conference, Hon Dr Michael Cullen, 26 June 2002.
[8] *Tax Review Final Report*, October 2001, pg 78.

$13.8 billion in 2000[9] over the same period as the FDI stock in New Zealand was static and overall business investment in New Zealand declined.

4.3 Many other countries have responded to the need to attract and retain investment, particularly FDI. Closest to home, Australia has clearly made attracting FDI a high priority. For example, in August 2002 the Australian Treasurer released a consultation paper reviewing its international taxation arrangements. KPMG Australia described the direction of the paper as 'pro investment, pro-growth, and pro-business' although it also noted that more reform would be needed to 'catapult Australia to regional competitive leadership'[10]. Australia has also reduced its corporate tax rate over the past two years from 36% to 30%, a rate that is now lower than New Zealand's. Meanwhile, Singapore is cutting personal and company tax rates to a maximum of 20% because it fears becoming unattractive as an investment location[11].

4.4 In Business New Zealand's view, the contrast with New Zealand could hardly be starker. While it is true that New Zealand does not have the high additional payroll taxes that are a feature of many other OECD countries, the headline rate of corporate tax is nevertheless an important consideration for investors. In this respect, New Zealand fares poorly. Whereas in 1988 a 33% corporate tax rate was highly competitive, the advantage has been steadily eroded over time, so much so that by 2002 New Zealand's corporate tax rate is now higher not only than the average for Asia-Pacific, but also the averages for the OECD and even the EU[12]. The international trends are clearly working against New Zealand retaining a 33% corporate tax rate.

4.5 Business New Zealand also considers that New Zealand should be very careful about comparing its tax burden with the OECD average or individual European countries. New Zealand's major trading partners and competitors for investment are mainly in the Asia-Pacific region. These countries generally have significantly lower tax rates and tax burdens than New Zealand.

4.6 Again, the officials' report disappointed in not exploring the international competitiveness issues behind attracting and retaining both foreign and domestic investment.

4.7 *Business New Zealand recommends that the Government recognise the importance of an internationally competitive tax system to attract and retain both foreign and domestic investment.*

4.8 On a related issue, it is also important that the problems associated with Trans-Tasman triangular taxation are resolved, as there is considerable anecdotal evidence that the status quo is hindering bilateral investment on both sides of the Tasman. The two Governments should now be working

[9] Ibid.
[10] *International Tax Review*, KPMG Australia advisory note, August 2002.
[11] *Lifting Our Act Means Growth Must Come First*, by Dr Murray Horn, NZ Herald, 29 November 2002.
[12] *KPMG Corporate Tax Rate Survey*, January 2002.

closely together to ensure that an investment-friendly solution (preferably the dividend streaming option) is implemented as soon as possible.

4.9 *Business New Zealand recommends that the Government should work proactively with the Australian Government to make the resolution of triangular taxation a high priority.*

5. Lower Corporate Tax Rate for All Businesses

5.1 The Tax Review's recommendation was to provide a lower tax rate for new FDI only. However, in Business New Zealand's view there is a stronger case for a lower corporate tax rate for all businesses, foreign and domestic.

5.2 The arguments for reducing the tax rate for FDI (particularly that of increasing business investment and the need for an internationally competitive tax system in order to attract this investment) are similar to those for a lower rate of corporate tax for all businesses. However, while Business New Zealand would usually welcome any proposal to reduce tax rates, we do not support a lower rate of corporate tax solely for either new or existing FDI while New Zealand companies are facing among the highest rates of corporate tax in the Asia-Pacific region.

5.3 Instead, Business New Zealand submits that a steady reduction in the corporate tax rate to around 20% in the medium term would be beneficial for international competitiveness and business investment, and would not impact detrimentally on the Government's overall fiscal position[13].

5.4 This is simply because corporate tax is primarily a withholding tax and is not necessarily a final tax, at least in the case of New Zealand resident shareholders. That is, income tax paid by companies is attributed to shareholders in so far as profits are distributed as dividends. Shareholders can use the associated imputation credits to reduce their personal tax payments, but the tax paid by companies on their behalf is seen as the individual's tax liability.

5.5 Dividends attract imputation credits, but these would be worth less if the corporate tax rate were cut, so leaving shareholders to pay more tax directly at whatever their marginal rate. Reducing the corporate tax rate would therefore increase the revenue collected from personal income tax, although not to the extent of fully offsetting the direct reduction in corporate tax revenue (particularly when companies have non-resident shareholders).

5.6 The major contributor to protecting revenue levels would be the result of the increased business investment and subsequent economic activity generated by the cut, which would ultimately result in higher taxable incomes (both corporate and personal). Increased job growth would also reduce transfer payments, so reducing Government expenses.

[13] This view is backed up by Business New Zealand's 2002 election survey, which found that 69% of members supported reducing the corporate tax rate to 20% by 2010, with 23% opposed (most of those opposed wanted the rate cut to 20% by earlier than 2010 or to a lower rate by 2010).

5.7 If businesses receive a tax cut, they are likely to 'save' the cut by investing in new plant and equipment and therefore increase their future potential output – surely a potent lever to lifting New Zealand's rate of sustainable economic growth. Also, the business sector is already a significant source of 'savings' in the economy and we believe that reducing the corporate tax rate would increase these savings further, so helping to lift overall national savings.

5.8 *Business New Zealand recommends that the Government should lower tax rates, with a priority on reducing the corporate tax rate for all businesses over time from 33% to 20%.*

6. Need for Dynamic Forecasting Model

6.1 The officials' report asserted that the revenue cost of a lower rate of tax for FDI would be $500 million per annum. We are concerned that the officials made these assumptions based on a *static* forecasting model. A significant weakness is that the report does not model the *dynamic* impacts of a lower tax rate on increased economic activity caused by higher investment, employment, etc that in turn leads to higher tax revenues from corporate tax, personal income tax and GST.

6.2 In 2001, Business New Zealand and Employers and Manufacturers Association (Northern) contracted economic forecaster Infometrics to model the impacts of a 20% corporate tax rate. The Treasury responded by criticising the assumptions behind the Infometrics model, and while we accept that the model was imperfect in some respects, we remain disappointed that officials have yet to offer an alternative. We believe that until dynamic effects are modeled it will remain all too easy for officials to discredit any proposals for tax rate reductions on the grounds that they would put significant revenue at risk, when the reality is likely to be somewhat different.

6.3 *Business New Zealand recommends that Treasury and IRD should develop dynamic models to forecast the fiscal and economic impact of changes in tax rates.*

7. Wider Economic and Regulatory Issues

7.1 Business New Zealand acknowledges that the Tax Review did not have a mandate to consider wider economic and regulatory issues. However, any discussion on investment, both foreign and domestic, must include wider issues that impact upon the attractiveness of a country as a place to invest and not be confined just to tax.

7.2 The Ministerial Panel on Business Compliance Costs identified a number of areas of concern to business. Not only do compliance costs impact upon local businesses and their propensity to employ and invest, they can also be a significant deterrent to foreign investment, particularly if they are more onerous than in competitor countries.

7.3 Legislation covering resource management, employment relations, accident compensation, health and safety in employment, hazardous substances and new organisms, and taxation, and their implementation by central and local government agencies all have the potential to turn off foreign as well as domestic investment. In relation to FDI, the Boston Consulting Group in its recent report to the Government was particularly critical of the Resource Management Act and its interpretation and implementation by local authorities[14].

7.4 While a recent OECD survey on compliance costs found that New Zealand rated very well, the results need to be read with considerable caution:

- Only 10 countries were surveyed, most of them highly regulated continental European and Scandinavian countries, so there would have been something very wrong if New Zealand had not done well in comparison;
- When adjusted for average firm size, New Zealand moved closer to the survey average;
- When adjusted for GDP, New Zealand's position worsened further; and
- Most of New Zealand's major trading partners (and competitors for FDI), particularly those in the Asia-Pacific region, were not surveyed.

7.5 New Zealand cannot afford to be complacent. Policies must have an explicit and deliberate growth promoting focus. Those that do not pass the 'growth test' should not proceed. Regrettably, since 1999 there have at best been mixed signals and at worst a large and growing number of policy decisions that have been inimical to growth, including:

- Renationalising ACC and reimposing a state monopoly for workplace accident insurance;
- Introducing a 39 cent top rate of marginal income tax;
- Decision to ratify the Kyoto Protocol ahead of our major trading partners;
- Rejection of proposed amendments to address problems with the Resource Management Act;
- Local government legislation, which will reduce efficiency and increase costs to businesses and ratepayers;
- Health and safety legislation, which will increase costs for employers and act as a disincentive to employ; and
- Poor quality government spending, such as the establishment of a state owned bank and what has been a veritable 'lolly scramble' of industry assistance handouts.

7.6 It is hard to imagine many credible commentators describing these decisions as being 'pro investment, pro-growth, and pro-business'. This graphically illustrates the differences in approach between Australia and New Zealand. New Zealand will continue to lose out in attracting FDI and business investment generally if something is not done to improve this situation.

7.7 *Business New Zealand recommends that the Government should do more to address the overall economic and regulatory environment to make it more*

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[14] *Building the Future – Using Foreign Direct Investment to Help Fuel New Zealand's Economic Prosperity*, Boston Consulting Group, 2001, pp 21-22.

conducive to both foreign and domestic investment and more competitive vis-à-vis other countries.

8.1 Conclusion

8.1 Since the late 1990s, business investment growth rates have been disappointingly weak, and the stock of foreign direct investment actually fell in the year to March 2002. Business New Zealand submits that if New Zealand is to achieve a higher sustained rate of economic growth and make a return to the top half of the OECD, then the Government must make a more focussed and concerted effort to implement policies that would encourage the a greater quantity and higher quality of business investment, from both foreign and domestic sources. These policies should include making New Zealand's tax system – including corporate tax rates – more internationally competitive, and removing compliance cost 'road blocks' to investment.

9. Recommendations

9.1 Business New Zealand recommends that:

(a) The Government should recognise the importance of higher levels of business investment, from both foreign and domestic sources, for a higher rate of economic growth;

(b) The Government should recognise the importance of an internationally competitive tax system to attract and retain both foreign and domestic investment;

(c) The Government should work proactively with the Australian Government to make the resolution of triangular taxation a high priority;

(d) The Government should lower tax rates, with a priority on reducing the corporate tax rate for all businesses over time from 33% to 20%;

(e) Treasury and IRD should develop dynamic models to forecast the fiscal and economic impact of changes in tax rates; and

(f) The Government should do more to address the overall economic and regulatory environment to make it more conducive to both foreign and domestic investment and more competitive vis-à-vis other countries.